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Inclusive growth in India through Islamic banking

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Abstract

Indian economy has been growing, but paradoxically the rate of poor people is also on the rise. The State must endeavour to establish an egalitarian society. However, most of the Indian citizens do not have access to credit. The present banking system is not conducive for protecting the interests of all sections of the population. The banking system of Islam, based on Islamic law (Shariah), has been institutionalised in many parts of the world in the last couple of decades. Islamic banking is interest-free banking system based on real asset and risks are shared between lender and borrower under the mechanisms of partnership, joint ownership, lease and sale. Money is considered only as a medium of exchange, unlike the conventional banking, where dealing in interest being a main product, implies that money is traded as a commodity. Islamic banking has the potential to uplift the vulnerable groups such as farmer and Small and Medium Enterprises (SMEs) and can fosters inclusive economic growth. Besides, there is a strong argument that interest-free finance may attract investment from the Gulf region. Finally, it provides impetus to the socialist goal envisaged by the Constitution. There are several studies including Planning Commission Report of 2008, favouring Islamic banking in India. Apart from the objections on theoretical grounds and its working, it is not possible to establish such banking system under the present legal regime. However, it seems that the recent trend in India is to promote religious law for advancing the goal of secular law. In this context, the Kerala High Court has upheld the constitutional validity of Islamic finance in the case of Dr. Subramaniam Swamy vs. State of Kerala & Ors. (decided on 3rd February, 2011). An attempt has been made to demonstrate the viability of Islamic banking.

Keywords: Financial Inclusion; Islamic Bank; Islamic Banking; Islamic Finance; Inclusive Growth

1. Introduction

Under the scheme of distribution of wealth, the State should ensure the supply of basic necessities to all citizens, and must also give them an opportunity for achieving the highest possible perfection according

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to their respective aptitude. However, even the prosperous countries of the world failed to achieve this goal. Concentration of wealth in a few hands is the feature of every society. Several mechanisms exist by which resources may be hoarded and inequality is caused. The process of lending and borrowing on interest is one of the most notorious tools developed by man for creating disparities, though it is institutionalised to such an extent that it is considered as part and parcel of day-to-day transactions and inevitable for the working of the economy. However, none of the theory of interests convincingly justifies the payment of interest. The central argument of most of the theorists is that interest is a reward for the painful act of saving or giving up the present satisfaction. Alternatively, some claim that capital deserves reward because it is productive in the sense as land is productive of crops. It is important to note that people in general do not undergo hardship of saving at the cost of the basic necessities, and in the real life the savers are rich people. The second argument fails to consider that loans on interest are not given only for productive purposes but are also allotted for purchasing houses and cars. Thus, it does not apply for consumption loans. In fact, less than 2% of the wealth is used for the productive purposes and the rest are being devoted to derivatives, consumer credits, bidding of assets prices etc. Political colonisation is substituted by economic colonisation and the conventional banking system is one of the major players in this regard. In countries such as the U.K., 97% of money is supplied by banks. It reveals that only 3% of the total money is debt-free and most of the remaining is debt-ridden, without any real thing behind it. The system of interest is legally channelled through banks and the privilege of creating credit adds insult to injury. In short, a perfect money factory is developed over the last 400 years or so in the form of bank by which wealth is concentrated. The two basic flaws in the understanding of monetary setup are: i) banking institution is merely an intermediary between lender and borrower and ii) the perception that money is limited. In the prevalent atmosphere of inequitable distribution of wealth, banking system of Islam (Islamic Banking) may be considered as an alternative for countries like India. The aim of this paper is to trace the rationales for experimenting Islamic banking in India, which among other things promotes the constitutional mandates in a better manner and in a way, comparison is made between conventional banking and Islamic banking.

1.1. Modus operandi of Islamic bank

Under Islamic banking system, risks are shared between lender and borrower, as dealing in interest is prohibited and business affairs are backed by real assets. Money is considered only as a medium of exchange unlike conventional banks where money is traded as a commodity. These apart, bank cannot enter into certain transactions such as businesses of alcohol, speculation and gambling in *Shariah.* Generally, Islamic banks agree to the basic principles of *Shariah* and they conduct their operations in conformity with those tenets. In actual working, however, they sometime differ because of variables such as laws of a country, bank's objectives, requirement of interaction with conventional banks etc. Islamic banks have three kinds of accounts namely; current account or deposit account, investment account and savings account. The current account of Islamic banks is similar to current account of conventional banks. In investment account, capital is not guaranteed and investors agree in advance to share profit or loss at an agreed ratio. Finally, savings account is operated in several ways. In some systems, initial deposit is guaranteed and profit is also shared and in some places capitals are not guaranteed by banks and it is treated as investment account and banks only invest in risk-free projects. Hence, depositors get lower rate of profit. Moreover, Islamic banks also provide services such as money transfer and bill collection. The traditional modes of Islamic trading system still dominate the bank transactions, which may be broadly classified as trade based (Buyer-Seller relationship and Co-ownership), rental based (Lessor-Lessee relationship) and equity based (Partnership and Joint Venture relationship). These modes are also structured in the form of Islamic bond (*Sukuk*) and Islamic insurance (*Takaful*).

1.1.1. Partnership

Three kinds of partnership are recognised. The first one is called *"Musharakah"*, which literally means sharing. In this type of partnership, two or more persons agree to share profit and loss at the predetermined ratio and other principles of general partnership are applied. Another form of partnership is called *"Mudarabah"*. In this case, one partner invests the capital (*Rabb-ul-mal*) and the other (*Mudarib*) applies his entrepreneurial skills and labours and has the exclusive responsibility of the work. Bank enjoys both the positions. When the bank accepts deposits, it is an entrepreneur while in case of investing, it is an investor. In the third form, the combination of *Mudarabah* and *Musharakah* in one transaction takes place where an entrepreneur has invested some capital and also applies his management skills. In this type of transaction, apart from getting profit for his entrepreneurial skills, entrepreneur may also be entitled to certain percentage of profit on account of his investment. The parties are free to agree at any percentage of the profit but the sleeping partner's ratio of profit should not be more than his proportion of investment.

1.1.2. Sale

Sales are also of three different categories. The general kind of sale is called *"Murabahah"*. In the *Murabahah* transaction, the seller discloses the actual cost including freight and custom duty of a commodity to the purchaser and agrees to provide him the commodity on a certain profit (profit may be lump sum or in percentage) added to his cost. It is popularly referred to as the "cost-plus" transaction. The transaction of *Murabahah* is completed in three steps. Firstly, the bank and client enter into an agreement whereby the former promises to sell the commodity at certain profit and the latter agrees to purchase the same. Secondly, bank purchases the commodity from the supplier and the client makes an offer to purchase. Alternatively, the client may also buy from the supplier on behalf of the bank and acts as a mere trustee or agent of the bank and the ownership vests in the bank. Finally, transaction is completed with the execution of an offer and acceptance. Thus, bank must have the ownership of the subject matter of the transaction and it must be in its actual or constructive possession. *Murabahah* transaction must comply with certain rules, most of which are similar to general sale. In regard to the subject matter, *Murabahah* may be used where the client needs funds to actually purchase some commodities and not for other purposes like paying the price for already purchased commodity, paying electricity bill or giving salaries to staffs. Besides, *Murabahah* takes place only of existing goods and not of future goods and the goods must have some real or intrinsic value measurable in monetary terms. *Murabahah* can be used for short / medium / long term finance for: raw material, inventory, equipment, asset financing, import financing, export financing (pre-shipment), consumer goods financing, house financing, vehicle financing, land financing, shop financing, tour package financing, education package financing, all other services that can be sold in the form of package (e.g; services like medical as a package). Regarding security and guarantee, the bank will ask the client to furnish the security in the form of mortgage, hypothecation, lien or charge. The security may be the subject matter of the *Murabahah* itself or some other thing not less than the value of the subject matter. Alternatively, the bank may ask for the third party guarantor. In addition, bank may also obtain a post-dated cheque or promissory note from the client. It is also a necessary condition for the validity of *Murabahah* that the commodity is purchased from a third party. The purchase of the commodity from the client on 'buy back' agreement is not allowed in *Shariah.* The price cannot be increased even if buyer fails to pay the price at an agreed due date. At the most, the buyer is liable to pay an amount for the charitable purpose if he has given the undertaking in the agreement and the amount so recovered shall not form part of the income of bank and should be spend in a charitable purpose for which bank maintained a separate copy.

The second type of sale is called *"Bai Salam"*, which is actually an exception of *Murabahah*. In this category, the seller promises to supply some specific goods to the bank at some future date for which the price has been fully paid. The reason for the introduction of this type of sale is to fulfil the needs of farmers, importers and exporters. They are allowed to sell their goods in advance. Farmers need money for growing crops and feeding their families till the time of harvest and importers and exporters may need cash as it normally takes few months for them to realise cash for their sale. *Salam* is beneficial to both the parties. Seller realises the cash immediately and bank is able to purchase at a lower price. The difference of the two prices is the profit for banks. Among the essential conditions, bank must pay the full price at the time of the sale so that the instant need of the seller is satisfied and to avoid debt against debt which happens in case of part payment. Besides, a particular commodity or the product of a particular field or farm cannot become the subject matter of *Salam* as contingency is attached to it. Further, the commodity must be one whose quality and quantity can be ascertained but need not belongs to a group where *Shariah* required instant delivery. From the contract of *Bai Salam*, bank can benefit in two ways. Firstly, the commodity may be sold by *"Parallel Salam"*. In this mode, the bank enters into two distinct contracts with two different persons. Bank is buyer in one contract (*Salam* contract) and seller in another contract (Parallel *Salam* contract) and both contracts are independent of each other. The difference between the price of the primary and parallel *Salam* is the profit of the bank. Secondly, bank may also obtain unilateral promise to purchase from a third party and may fix the higher price and merely being a promise, the expected purchaser need not pay the price in advance.

The third form of sale is called *"Istisna",* which is the second exception of *Murabahah* It is a kind of sale where manufacturer undertakes to manufacture a specified commodity for a purchaser in consideration of a certain price. The subject of *Istisna* must be a thing capable of being manufactured. Before the commencement of work it may be terminated at any point of time by either party serving notice to the other. It is not necessary to fix the exact date of delivery and fixation of a maximum period within which the manufacturer should deliver the goods is sufficient. To ensure delivery on time, a penal clause may be added to the agreement. *Istisna* can be used in construction of house, bridge or highway, where banks may build a house for the client through its agent or by entering into the contract of Parallel *Salam* with third party. In both cases, bank will calculate the cost and fix the price in a manner which may give it a reasonable profit. The arrangement regarding payment of price may be agreed by the parties in any manner including payment at the time of delivery or on the basis of installment. As a security, bank may keep the title deed of the property till the last installment is paid.

1.1.3. Lease

Islamic lease is called *"Ijarah"*, which lexically means to give something on rent. In the present context, *Ijarah* is related to usufructs (benefits) of assets or properties and signifies the transfer of usufructs for fixed period in exchange of certain rent or price. The conditions for valid *Ijarah* are similar to general lease. Instead of giving interest-bearing loan, some banks, especially in Western countries leased out equipment to their customers. Banks calculate the total cost they have incurred in the purchase of the assets and add the stipulated interest they could have claimed and replace the latter with monthly rental during the lease period.

1.1.4.Joint Ownership

Joint Ownership is called *"Diminishing Musharakah"*. In this mode, bank and client enter into a joint ownership of a property. The share in the property is divided into number of units and the client purchases the units from the bank one by one on the periodical basis, thereby increasing his own share till all the units are purchased by him, making him the sole owner. The steps involved in *Diminishing Musharakah* are as follows:

Step 1 – The first step is to create a joint ownership in the property.

Step 2 – Bank gives its share to client on rent.

Step 3 – Promise made by the client to purchase the units of share of the bank and to pay rent.

Step 4 – Actual purchase of the units at different stages and payment of rents as per the proportion of bank's share in the property.

Step 5 – Transaction is completed when the payment for the entire units is given by the client to the bank.

It is mostly used in house financing. To illustrate, say a client wants to purchase a house valued at ten lakhs rupees and he has only one lakh rupees. Therefore, he can only afford 10% of the actual value of the house. So, 10% amount is paid by the client and 90% amount is paid by bank. At the initial stage, client owns 10% of the house and bank owns 90% share in the house and the share of bank is divided in nine equal units; each representing 10% ownership. Now, client promises to purchase one unit in one year and also promises to pay rent for the proportion of the bank's share which will keep on decreasing after each year. Considering the rent of the house is Rs. 1000/- per year, at the end of first year client has to pay Rs. 900/- to bank as a rent and Rs. one lakh for $1/10^{th}$ of the price of the house. The share of the client increases by 10% making him the owner of 20% and bank's share comes to 80% from 90%. Similarly, in second year, client will again pay one lakh for 10% ownership and Rs. 800/- as rent because in the second year, bank owns only 80% of the share. This process continues and ultimately client will purchase the entire share of the house after nine years, thereby making him the sole owner and he need not pay rent to the bank anymore as the transaction is completed. In short, bank can claim rent as per its proportion of ownership and simultaneously entitled for periodical return of the principal amount. *Diminishing Musharakah* may also be used as a mode of financing for purchasing vehicle or for opening new business.

Thus, from the perspective of banks, Islamic modes of finance may be classified into fixed-return and variable returns. The former includes sale and lease and the latter comprises of partnership and joint ownership.

1.2. Rationales for implementing Islamic banking in India

India has never experienced Islamic banking system but Islamic finance has been experimented from time to time under Non Banking Financial Companies and *Shariah*-complaint products are also offered by companies. In the recent past, however, some people have been trying their best to propagate the idea of Islamic Banking. In the global perspective, it is interesting to note that some of the earliest research on Islamic banking came from scholars at Osmania University in Hyderabad and Allahabad University in Uttar Pradesh. The rationales for implementing Islamic Banking are

1.2.1. Inclusive Growth

1.2.1.1. Through Equitable Distribution of Wealth

Indian economy has been growing considerably and the share of the financial sector in the Gross Domestic Product (GDP) has increased in the recent years. However, it seems to favour the corporate sector than vast sections of the population living below the poverty line as the latter is constantly increasing. The extension of debt finance by commercial banks and interest rate sensitivity to inflation are well known. Islamic bank assist in equitable distribution of income by encouraging equity finance unlike the conventional banking, which actually helps in promoting concentration of wealth. In the present setup only rich can ask for loan because furnishing of collateral is the main criterion for obtaining money. If industrialist (borrower) has made a profit, he will pass a small percentage of it to the bank and the bank will pass even smaller percentage to savers (account holders). The cost of a product includes the amount of interest paid to bank. It implies that saver has to pay interest for purchasing every product, as interest is included in the cost of production. Nothing is in favour of common man. This mystery may be explored with the help of the following illustration. The condition of the total number of depositors can be explained by taking a case of just one depositor because all of them deposit their money in the same banking system running throughout the country. Suppose Mr. X has deposited Rs. 100 in savings account and got Rs. 105 at 5% interest and Mr. Y is an entrepreneur who has borrowed money from the bank at 10%. This is so because the bank must charge higher percentage of interest than returning it to savers for making profit. Mr. Y has manufactured a product and Mr. X wants to purchase that product. The cost price of raw materials required for making one piece is Rs. 100 in which Rs. 10 is added as Mr. Y will pay Rs. 10 to bank. Mr. Y is also expected to earn a legitimate profit of Rs. 5 on each product for his time, labour and skills. The total cost price therefore is Rs. 110 (Rs. 100 for raw material and Rs. 10 for interest) and selling price is Rs. 115 (Cost Price + Profit). By paying Rs. 115 for each product, Mr. X actually losses Rs. 5 in the interest-based system. The actual valuation of initial amount may be arithmetically represented as: AC = TA + IE – IP

Where, TA = Total Amount Deposited; IE = Interest Earned by the Depositor; IP = Interest Paid by the Depositor; and AC = Actual Valuation of Money. In the given case AC = Rs. 95 (100+5-10)

The situation is worse in case of meeting recurring expenses because Mr. X has to pay Rs. 10 extra for which he is not getting anything in return as he needs to keep some cash in hand. This system also encouraged rich businessmen to charged higher profit even if they are not availing money from bank because the cost price of other manufacturers includes interest and that become the general market price. This system is worst for those who have nothing to save because even they have to pay interest for each slice of bread they buy. On the other hand, in case of loss, by taking the extreme situation when bank goes into liquidation, the losses are shared by all class of savers including rich and poor. The proposition is – if there is a profit, the whole profit goes to rich and losses are suffered by rich as well as poor. Thus, under the present banking system rich have the unfettered right to withhold capital.

1.2.1.2 Financial Inclusion of Muslims

The Sachar Committee report stated the importance of access to credit for individuals, households and firms for the purposes of consumption, production and investment. The Committee, which studied the socio-economic conditions of Muslims in India vis-à-vis other minority communities reveals that Muslims are the disadvantageous community in financial sector. The Committee report reflects that Indian Muslims have a share of only 7.4% in saving deposits and gets 4.7% in credit (in terms of Priority Sector Advances). Comparing with the standard proportion in deposits and credits as laid down in the annual report of the RBI for the year 2007-08, Indian Muslims annually lose around Rs. 63,700 crores. Similarly, as per the survey conducted by Reliance Money, 35% of the Muslims live in urban areas and 80% of them because of their illiteracy, ignorance or belief; the last playing an equally important role, do not avail banking facility. In another survey, it was observed that 80% of Muslims in urban India are willing to deposit or invest in Islamic Financial Institutions on a profit/loss sharing basis. 67% of Muslims in urban India are willing to borrow from Islamic Financial Institutions on a profit/loss basis. The present system has paved way to exploit and cheat Muslims' funds. Some of the Muslims never invest in interest-based organizations and financial institutions have been established under NBFCs just to manipulate Muslims' funds. In the present scenario, either Muslims are likely to become victims of these cunning people or invest in unproductive investment like buying estate. Alternatively, they may keep their money idle in their home and just wait and watch the monetary valuation going down every moment; thanks to inflation. It hampers mobilisation of Muslims' savings and hence obstructs economic growth. Islamic bank could well be the solution. In this context, the RBI report of 2005 outlines that interest-free banking is an attractive proposition gaining currency all over the world and so it is time for India to introduce it.

1.2.1.3. Upliftment of Farmer

Agriculture is still the mainstay of the Indian economy as it serves the basic source of livelihood for more than 50% Indian workers. These workmen should have kept pace with the growth of service sector but the developing economy has become suicidal economy for them. According to BBC News, 2,00,000 farmers have committed suicide in India since 1997. Apart from the menace of globalization, the prime reason for these tragic ends to life is failure to pay interest-ridden debt. For amelioration, interest free system may play a big role. In this regard, Islamic product like *Bai Salam* and *Istisna* may be used for the benefits of farmers.

1.2.1.4 Growth of Small and Medium Enterprises (SMEs)

Lending to SMEs has been reduced because of relatively high transaction cost and risks. The Reserve Bank of India (RBI) reported decline in SMEs credit from 15.1% in 1990-91 to 6.5% in 2006-2007. An interest-based system discourages innovation, particularly on the part of small-scale enterprises. Large industrial firms and big landholders can afford to experiment with new techniques of production as they have reserves of their own to fall back if the adoption of new practices does not yield a good dividend. Small-scale enterprises hesitate to go in for new methods of production with the help of money borrowed from banks because the liability for the principal sum and interest has to be met. They have no other choice due to lack of reserves of their own. Besides, the interest-based system is security-oriented and not growth-oriented. The banks' commitment to pay a pre-determined rate of interest to depositors make them concerned about the safe return of the principal loan along with the stipulated interest. This lead them to confine their lending to the already well-established big business houses or to parties who are in a position to pledge an adequate security and when such avenues of lending are not sufficient to absorb all their investable resources, they prefer to invest in government securities with a guaranteed return. This exaggerated security orientation acts as an impediment to growth because it does not allow a smooth flow of bank resources to many potential entrepreneurs, who could add to the gross national product by their productive endeavour but do not possess ample security to pledge for satisfying the criteria of creditworthiness. Thus, conventional banking is not based on the viability of the project but Islamic banking by giving due consideration to the strength of the project, makes it possible for competent entrepreneurs from the poor and the middle-classes to be at least considered for financing if they have worthwhile projects, adequate managerial ability and a reputation for honesty and integrity. This may enable society to harness the pool of entrepreneurial ability from the lower strata of the society. Most of the people are apprehensive about loan losses from such financing. In this regard, the experience of the International Fund for Agricultural Development (IFAD) is that credit provided to the most enterprising of the poor is quickly repaid by them from their higher earnings. Other small-loan programmes have yielded similar results in several countries. Hard working peoples like farmers are committing suicides mainly because they fail to repay their interest-based loan instead of being dishonest to other by indulging in robbery or theft. Nevertheless, it is desirable to arrange insurance of small loans to provide protection to financiers against fraud and mismanagement.

With the introduction of Islamic products like *Mudarabah*, funding to SMEs may be increased leaving them with only operational cost unlike suffering the financial risks in the present arrangement. It will ensure sustainability in SMEs, which in turn promote the economy of India as SMEs constitute 80% of the total industrial enterprises and have a 40% share in industrial output.

1.3. Gulf Investment

With the establishment of Islamic banks, it is estimated that trillions of dollars can flow to India from Gulf (Headlines India 2010), as people from that region are investing their surplus in *Shariah*-compliant institutions. At present, almost all the money is deposited in the Islamic banking windows in London, New York, Zurich and Frankfurt. However, due to manipulation of fund in the recent past, they are looking for a safe investment destination. India could well be that destination given its safe economic scenario, huge market, skill and educated labour and good growth rate (Raqeeb A 2010). This estimated fund from Gulf is sufficient to create more than 2.7 million jobs in India. It will also assist in reducing the fiscal deficit. Comparing the present position of India, it lacks far behind in terms of export. Even the tiny Taiwan, exports double the volume India does.

1.4. Promotes Constitutional Goals

The Preamble, the Fundamental Rights and the Directive Principles of the State Policy (Directives) are the three main pillars of the constitution for ascertaining the constitutional goals. The preamble provides the object of the constitution and the other two enumerate the rights guaranteed to the people. The basic difference between the Fundamental Rights and the Directives is that the former are enforceable rights directing the State to act negatively and the latter demand affirmative action on the part of the State by incorporating the idea of welfare state, but are non-justiciable. Nevertheless, Directives are the fundamentals in the governance of the country and the State is under duty to apply them in framing its economic policies and laws. They got special weightage since judiciary has started interpreting them in harmony with the fundamental rights. Similarly, there is also a direct relation between the Directives and the preamble. The objectives of the Indian polity as stated in the preamble are sought to be clarified, strengthened and concretised through the Directives.

In spite of some initial conflicting argument at the time of the drafting of the constitution, at a cursory glance on the Directives, one may conclude that the socialist agenda was in the mind of the constitution maker at the time of the framing of the Constitution. It got formal recognition by the 42^{nd} Amendment of the Constitution in 1976; which added the word "Socialist" in the preamble incorporating the philosophy of socialism. The concept of socialism has been used with the Directives to assess and evaluate economic legislations. The basic framework of socialism is to provide a decent standard of life and security to the working people. The Court directed the State to put efforts towards equitable distribution of income and maximisation of production for solving the problems of unemployment, low income and mass poverty and to bring about a significant improvement in the national standard of living. There will be a fair distribution of the national cake and the worst off shall be treated in such manner as to push them up the ladder. In this context, Article 39 in general and Clauses (b) and (c) of that Article in particular are relevant for ascertaining the socialist's goal. Clauses (b) and (c) of Article 39 affect the entire economic system in India. Article 39 (b) directs the state to control and distribute the material resources of the community to the common advantages. The term "Material resources of the community" include such resources in the hands of the private persons and not only those which have already been vested in the State. It includes all things which are capable of producing wealth for the community. Article 39(c) discourages concentration of wealth. This apart, and even more importantly, from the enforceability perspective, there are hundreds of Fundamental Rights given in Part III of the Constitution, which the State promises to provide to its citizens.

The question is – Whether the present banking setup is in tune with the constitutional goals? Firstly, the system of bank lending is not always in conformity with "Equal Protection of the Laws" guaranteed under Article 14 of the Constitution, which entails positive action on the part of the State; implying empowerment of the lower class by showering special benefits. Lending on the basis of collateral is against affirmative action when the loan is given to certain classes of people like farmers; those who are entitled for special treatment. Moreover, under obligation to return money with interest and often on compound interest is also against the principle of positive discrimination. For example, if Rs. 100/- is lend out to farmer at 10% per annum on compound interest, the farmer has to return Rs. 110/- at the end of the first year. The amount keeps on increasing in case of default. Affirmative action means paying even less than Rs. 100 or Rs. 100 at the most, so that some benefit may be obtained. Thus, the constitutional goal of equality of status and opportunity is not implemented. The financing of project on the profit/loss basis by Islamic banking is better option to people like farmers. Islamic banking ensures that if there is loss by drought or any other reasons except negligence on part of the farmer, the loss shall be shared between farmer and bank. This risk sharing basis provides justice to the farmer-lender relationship.

The second objection against conventional banking comes from Article 19. Article 19 gives the citizens of India a right to carry on any occupation, trade or business subject to public interest among other limitations. One may ask from where the bank gets the authority to create new money which never existed in the economy. This kind of trading which leads to evil of inflation is against public interest. In this regard, it has been very rightly pointed out in *Fatehchand vs. State of Maharashtra* that money-lending to poor villagers does not come within the ambit of trade and commerce as it is exploitative of the village people. Such an activity has been considered as ‘anti-social, usurious, unscrupulous’. Islamic banking being equity-based, creation of money is not possible.

Thirdly, in the present environment of inflation caused by the interest-based economy, some of the fundamental rights become meaningless. Right to food has been recognised as a fundamental right and it is an obligation on the State to provide food to every citizen. However, where price keeps on rising every day as State mints more and more money which does not exist in reality, the State is unable to provide food in spite of all the five year planning and other measures as food crisis is the natural outcome of inflation. The corollary of this restricts the other fundamental rights to mere paper tiger.

The rationale for incorporating Islamic banking in India may be concluded by the passage of the 2008 report of the Planning Commission panel on financial sector reforms headed by Raghuram Rajan. The report recommended for the introduction of interest-free banking. The final report included the following paragraph:

Another area that falls broadly in the ambit of financial infrastructure for inclusion is that of interest-free banking. Certain faiths prohibit the use of financial instruments that pay interest. The non-availability of interest-free banking products (where the return to the investor is tied to the bearing of risk, in accordance with the principles of that faith) results in some Indians, including those in the economically disadvantaged strata of society, not being able to access banking products and services due to reasons of faith. This non-availability also denies India access to substantial sources of savings from other countries in the region. While interest-free banking is provided in a limited manner through NBFCs and cooperatives, the Committee recommends that measures be taken to permit the delivery of interest-free finance on a larger scale, including through the banking system. This is in consonance with the objectives of inclusion and growth through innovation. The Committee believes that it would be possible, through appropriate measures, to create a framework for such products without any adverse systemic risk impact.

Moreover, the studies conducted by Kerala State Industrial Development Corporation (KSIDC) for the formation of an Islamic Investment Company in Kerala has concluded that Islamic financial institution has the genuine commercial potential to become a global player. The feasibility report was prepared by M/s. Ernst & Young (P) Ltd., Mumbai (Dr. Subramaniam Swamy vs. State of Kerala & Ors 2010).

2. Legal Roadblocks

Indian banking laws do not expressly prohibit Islamic banking. However, apart from permitting basic banking product like current account, the Banking Regulation Act, 1949 is against the five basic principles of Islamic banking. The Act permits dealing in interest and prohibits investment in profit/loss sharing, dealing in partnership, buying, selling and barter of goods and using immovable property for any use other than private purpose. Besides, equity finance will also be examined in the light of the restrictions under Section 19(2) of the Act. The Act even disallows an Indian bank from floating a subsidiary abroad to launch such products, or offering these through a special window. This has created an obstacle on international level. A number of domestic banks are expanding their reach beyond the boundaries of India into the global arena, often launching business in countries where Islam is a dominant religion. Banks find it tough to compete in such countries as others are offering such products. Furthermore, Islamic banks cannot interact with the RBI because banks in India have to necessarily keep fractional cash reserve with the RBI. Banks should also maintain deposit account with the RBI over which they get interest. A bank licensed by the RBI becomes part of the monetary system, which means it can create money by deposit generation through deposit acceptance. Since these assets are interest based, Islamic bank cannot hold them. Islamic banks cannot interact with conventional banks due to problem of interest. Thus, to incorporate Islamic Banking in India, suitable amendments need to be made in the banking laws. Some changes also need to be done in taxation law. The first concern is about unnecessary double taxation, which may discourage Islamic financing. In some Islamic products like *Murabahah*, *Bai Salam* and *Istisna*, the ownership of the property is transferred twice before the actual delivery of possession to the client. The bank first owns the property by paying necessary stamp duty and at the time of transferring to the client, again stamp duty has to be paid because ownership is re-transferred. Secondly, an uneven approach to charging heavy tax on returns on equity investment as opposed to certain exemption of interest earnings would put Islamic Banking at a disadvantageous position because it is equity-based and prohibits interest.

3. Market Analysis and Strategic Planning

3.1. SWOT Analysis

It is a mechanism for evaluating the favourable and unfavourable internal and external factors in a venture. Internal consists of strengths and weaknesses. The former are the advantages of the venture over other industries and the latter are the disadvantages relative to others. External comprises of opportunities created by the venture and threats which the business has to cope. The SWOT analysis of Islamic Banking in India is represented as follows:

External Factors	**Internal Factors**
Strengths	*Opportunities*
1. Considerable no. of Muslim Population in India (Around 14%) 2. Demand for niche product is increasing in India	1. Benefit to Indian Economy by Gulf Investment 2. Addresses the issue of financial inclusion 3. Upliftment of farmer, SMEs & scope for Inclusive growth. 2. Potential to bridge the rising income disparity created by improper mobilisation of money
Weaknesses	*Threat*
1. Non awareness 2. Lack of experts 3. Amendments in Laws needed	1. Expected to become political weapon, maybe under the shield of secularism

Thus, prima facie the strengths and opportunities exceed weaknesses and threat. Besides, weaknesses can be removed very easily. Creating awareness and grooming experts is just a matter of time. However, due to fundamentalist attitude of a few, the debate on secularism may so on for decades.

3.2. Michael Porter Five Forces Analysis

It is a business strategy made up of five forces covering external and internal forces for determining the competitive intensity or attractiveness of the business. In other words, the following forces are use to look at the viability of the project in its ability to serve the customers and making profit: i) Bargaining power of customers – What is the nature of the ability of customers to put the business under pressure? ii) Bargaining power of suppliers – How strong is the position of sellers? Do many potential suppliers exist or only few potential suppliers or monopoly? iii) Competitive rivalry among the existing players – Does a strong competition between the existing players exist? Is one player very dominant or are all equal in strength and size. iv) Threat of substitute products – How easy can a product or service be substituted? v) Threat of new entrants – How easy or difficult it is for new entrants to start competing? The application of Porter's analysis to Islamic Banking displays the following result (Fig. 1):

4. Roadmap for India

For a permanent solution, it is imperative that the method for solution should be complete. There is no scope for half measures like simultaneous operation of conventional banking and Islamic banking under one roof. Therefore, it would be ideal to strive for "Interest-free Economy" based on cent percent reserves for upholding larger public interest instead of providing unnecessary option of creating money by pressing computer buttons. However, it would bring a radical change in the entire economy of the nation. Therefore, it would not be a wise idea to transform India into interest- free economy from interest-based economy overnight. It is suggested that India should make necessary amendments in the banking law, preferably separate legislation for Islamic banking and allow Islamic banks to run concurrently with conventional banking. This may be done either by giving fresh licence to Islamic banks or allowing Islamic banking window in conventional banks and further research should be done in the period of transition to plan for interest-free economy. Some people unnecessarily claim that the term “Islamic banking” is against the secular fabric of the Constitution. To avoid this misunderstanding, it is recommended that instead of calling Islamic banking, we may name it “Interest-free banking”.

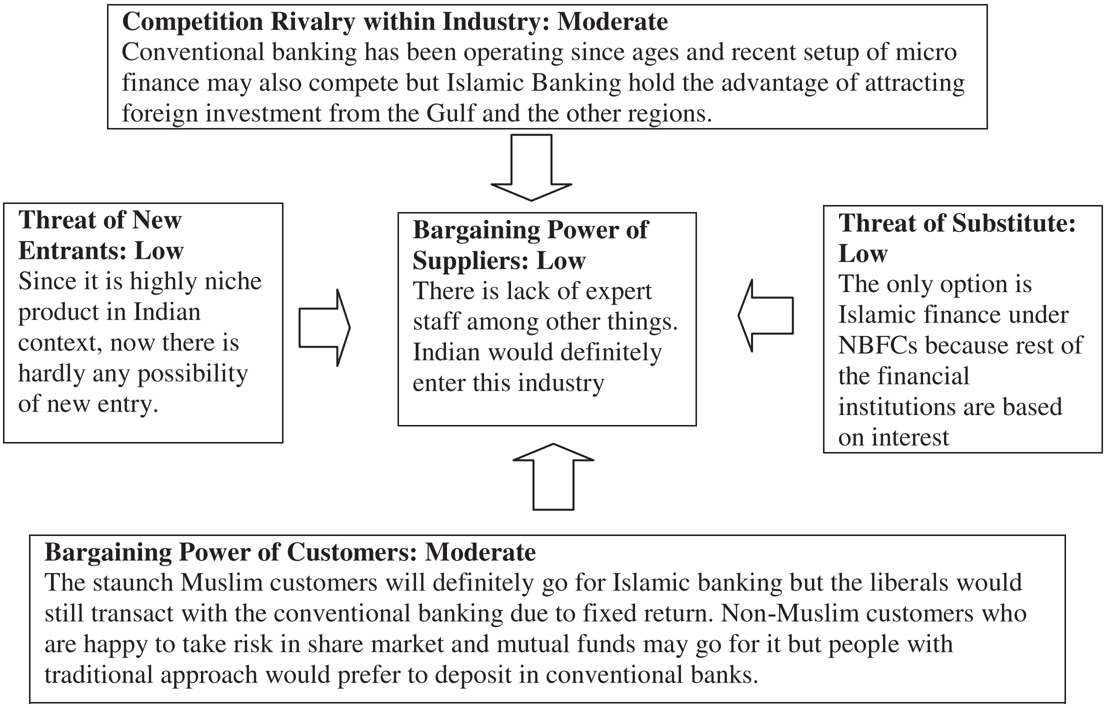

Fig 1.

5. Conclusion

The present banking system maintains the tempo of concentration of wealth by transforming the historical role of money as a judge of commodities to merely a commodity. It is not conducive for most of the people and protects the vested interests. Besides, for the economy as a whole, it is not a sound strategy as it encourages the masses to spend beyond their means. Therefore, debt burden of the country keeps on increasing with every passing day. We live in the land of paradoxes. One of the objectives of any policy or legal system is to eradicate poverty by promoting equitable and sustainable economic growth. The paradox exists in the constitutional aim of equitable distribution of wealth and the exploitative banking practice. Again, justice demands affirmative action for the upliftment of the vulnerable classes, but paradoxically those who are better off are climbing further up the ladder while the worst off going further down and getting out. This is possible when all the rights are not properly given or implemented for the susceptible groups. As an alternative, a case has been made for Islamic banking. Unlike creating money from money and often putting burden on only one party, Islamic model encourages labour and appreciates risk-taking; bringing the parties on the same footing. But, there is great deal of challenge involved in implementing this model for at least two reasons. Firstly, there is lack of unanimity among the *Shariah* scholars and secondly, it is very tough for the people to go or just think beyond a system which is running for hundreds of years. It is just a matter of time when these obstacles would be taken care of. In the Indian context, Islamic system especially takes care of the needs of the people requiring special treatment, without denying any legitimate claims of the other group, which ensure justice and equality.

The idea of incorporating Islamic banking should be viewed from the telescope of the economy for achieving the constitutional mandates rather than looking from the lens of religion. It is important to remove misconceptions and misunderstandings of the masses and awareness should be created among common citizens, policy makers, bankers, politicians, businessmen and other stakeholders. Finally, proper marketing should be done. In the absence of sound and effective banking system, it is tough to imagine manifestation of justice and healthy economy. The benefits which Islamic banks could bring to India are just too tempting to ignore. One may wonder what makes India to stop in creating a setup which can fetch trillions and that too on equity-based terms. Poverty can be reduced either by economic growth consistent with the population growth or by reducing unnecessary consumption. Islamic banking provides for both – by financial inclusion and investment from Gulf, it ensure production of more wealth by utilising these investments. It will also reduce consumption which is encouraged by the interest-based system. To begin with, even if Islamic banking is introduce as an experiment for Muslims at the back of the mind, which is certainly not the case, India has approximately 180 million Muslim population and if countries like Malaysia having only 15 million Muslims can try Islamic banking and succeed; there is stronger case for India to succeed in this matter.

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